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Practice Groups:

Investment Management, Hedge Funds and Alternative Investments

Private Equity

SEC Staff Addresses Third-Party Endorsements of Investment Advisers on Social Media Websites

By Michael W. McGrath and Sonia R. Gioseffi

On March 28, 2014, the Division of Investment Management of the Securities and Exchange Commission ("SEC") published an IM Guidance Update that removes a great deal of uncertainty regarding social media use by investment advisers (the "March Update")[1] The March Update provides detailed guidance regarding the circumstances in which the SEC staff deems public endorsements, rankings, and commentary on a social media website of an investment adviser or its personnel to be consistent with the Investment Advisers Act of 1940, as amended (the "Advisers Act") and the rules thereunder.[2] Notably, the March Update modifies the SEC staff's prior position that an advertisement containing non-investment related client commentary may be a testimonial in violation of Rule 206(4)-1(a)(1) (the "Testimonial Rule") under the Advisers Act.[3]

The Advisers Act and the rules thereunder significantly limit the content permitted in investment adviser advertisements and define "advertisement" broadly, such that nearly any social media website maintained by an investment adviser, as well as the business use of social media websites by its personnel, would be subject to these limitations.[4] The business reasons for having a social media presence placed investment advisers' compliance officers in a quandary—how to craft compliance policies that appropriately balance the business need to use social media with regulations developed for print media that are, in many respects, fundamentally at odds with the interactive nature of social media.

Social Media and "Testimonials" Prior to the March Update

Prior to the March Update, the SEC and its staff had provided limited guidance on the application of the Advisers Act to the interactive nature of social media, and past guidance on communications via the internet has mostly focused on email communications and static website content.[5] The limited guidance that has been provided by the SEC staff has raised the possibility that many standard social media functions could violate the Testimonial Rule.

The Testimonial Rule prohibits an investment adviser from using testimonials in its advertising. The SEC staff has historically considered a "testimonial" to be any explicit or implicit statement of a client's experience with, or endorsement of, an investment adviser. The staff had previously extended this position to social media by stating that a client providing a "Like" on Facebook or a LinkedIn recommendation could be an impermissible testimonial, but the staff did not offer specific guidance on how to distinguish a permissible social media interaction from an impermissible testimonial.[6] This placed advisers in a difficult position, since some functionalities, such as the "Like" function on Facebook, cannot be disabled.

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The March Update

The March Update provides welcome clarification regarding the publication of real-time information on social media or the Internet, and it contains specific examples of social media interactions that would (and would not) be deemed to contain impermissible testimonials. Although it explicitly states that many common social media interactions will not be impermissible testimonials, the March Update also provides guidelines, including safeguards against the types of abuses that the Testimonial Rule was designed to address—namely, the risk that an investment adviser would emphasize favorable testimonials and ignore unfavorable ones, thus creating the misleading inference that cherry-picked testimonials are typical of the experience of the adviser's clients.[7] While the March Update does not name particular websites, it reflects an understanding by the staff of common social media websites that advisers may use, such as Facebook, LinkedIn, and Yelp.

Guidelines for Third-Party Postings

According to the March Update, an investment adviser that maintains or links to a social media site that contains public commentary (which may include client commentary) would not be in violation of the Testimonial Rule if it complies with the following guidelines:[8]

- *Independence of the Social Media Website*. The social media website must be independent of the investment adviser and its affiliated parties.[9] The investment adviser could advertise on the social media website if it is apparent that any public commentary is separate from the advertisement, and if the website does not alter the public commentary as a result of receiving advertising revenue.
- *Independence of Third-Party Commentary*. Neither the investment adviser nor its personnel may directly or indirectly author any commentary or pay others to author commentary.
- *Completeness of Content.* All public commentary must be viewable, and any searchable or sortable functions must be in a content-neutral manner.
- *No Modification of Content*. The social media website must allow for independent commentary on an unrestricted, real-time basis. Generally, if an adviser modifies third-party content in any way, including by suppressing, modifying or prioritizing any content, the content would be deemed an impermissible testimonial. However, the social media website may modify or remove content in accordance with its published content guidelines, for example, to remove defamatory statements, profanity, racially offensive statements or material that infringes on intellectual property rights.

Client Lists

The staff clarified in the March Update that, consistent with its prior guidance, it would not deem a list of contacts or "friends" on the social media website of an adviser or its personnel to be an impermissible testimonial, even if the list represented a partial client list. However, the staff cautioned that such a list could nevertheless be a misleading advertisement if there is an inference that the contacts or "friends" have experienced favorable investment results, or if the adviser otherwise manipulates or presents the list in a misleading manner.

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Community Pages

The March Update cautioned investment advisers against publishing content or linking to websites created by third parties that contain public commentary on "a myriad of investment topics," including the investment adviser or its personnel, especially if the investment adviser has a material connection to the website or is directly or indirectly responsible for its content.[10]

Scope of Guidance

The March Update relates only to the publication of information through independent social media websites and posting, linking, or otherwise referring to such information. The staff cautioned that the March Update does not relate to advertisements on paper, radio or television media and that it would continue to view selective reprints of third-party commentary as an impermissible testimonial. It appears, however, that the staff will now permit non-investment related commentary, such as comments on an adviser's religious affiliations or community service, in all advertisements (rather than only on social media).

Notably, the March Update focuses on an investment adviser's business use of social media, but it does not distinguish among business-related activities and the private activities of its personnel on websites that may encompass both professional and personal use, such as LinkedIn.[11]

Compliance Policies and Procedures

The SEC staff has stated that investment advisers with a social media presence should implement compliance policies and procedures that are tailored appropriately to their activities and their personnel.[12] In light of the March Update, investment advisers should consider compliance policies that:

- expressly identify the social media websites that the investment adviser and its employees may use for business purposes, and require approval by the firm's CCO or another appropriate officer to add websites to this list;
- prohibit employees from asking clients or the public to post comments about the adviser or any of its personnel, and, in particular, prohibit employees from requesting positive commentary or providing a benefit such as a discount in services in exchange for posting a comment;
- prohibit employees from posting unauthorized comments on the adviser's social media sites; and
- prohibit any manipulation of third-party posts on the adviser's social media sites.

Finally, investment advisers should consider implementing training related to social media that seeks to promote compliance with, and prevent violations of, the federal securities laws and the firm's internal policies.[13] Investment advisers should also consider whether their social media policies address applicable recordkeeping requirements, monitor compliance by their employees, and follow-up on any potential violations.

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[1] *Guidance on the Testimonial Rule and Social Media,* Guidance Update, Division of Investment Management, SEC, No. 2014-04 (March 2014) ("March Update").

[2] In rescinding this position, the staff noted the benefit that social media provides on "consumers' ability to research and conduct their own due diligence." March Update.

[3] Rule 206(4)-1(a)(1) does not define "testimonial," but the SEC staff has interpreted the "term to include a statement of a client's experience with, or endorsement of, an investment adviser." *Investment Adviser Use of Social Media*, National Examination Risk Alert, Office of Compliance Inspections and Examinations, SEC, Vol. 1, Issue 1 (Jan. 4, 2012) ("2012 Risk Alert").

[4] *See* 2012 Risk Alert.

[5] *Filing Requirements for Certain Electronic Communications*, Guidance Update, Division of Investment Management, SEC, No. 2013-01 (March 2013) and 2012 Risk Alert. Given the limited SEC guidance, many advisers referred to the Financial Industry Regulatory Authority's ("FINRA") three regulatory notices: *Supervision of Electronic Communications*, Regulatory Notice 07-59, FINRA (Dec. 2007); *Social Media Web Sites*, Regulatory Notice 10-06, FINRA (Jan. 2010); and *Social Media Websites and the Use of Personal Devices for Business Communications*, Regulatory Notice 11-39, FINRA (Aug. 2011).

[6] 2012 Risk Alert.

[7] Advisers need to continue to be mindful of the facts and circumstances in their use of social media and, in particular, be mindful of Rule 206(4)-1(a)(5).

[8] The staff did, however, caution that what is or is not an impermissible testimonial would depend on the facts and circumstances, and the adviser would be subject to other provisions of the Advisers Act.

[9] The staff, in the March Update, clearly limited its guidance to third-party websites with no material connection to the investment adviser or its personnel. Although third-party reviews on proprietary websites are increasingly common in the consumer goods space, the staff would consider such reviews an impermissible testimonial pursuant to the March Update.

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[10] The staff has previously noted that an investment adviser may be deemed to "adopt" the content of such a site, or to be "entangled" with the creation of such a site, such that the adviser is responsible for the content and its compliance with the advertising rules under the Advisers Act.

[11] In determining the appropriate supervision of employee use of social media, advisers must be mindful of state privacy law requirements. *Social Media at the Intersection of Personal and Professional: Challenges for Investment Advisers and Broker-Dealers*, S. Gioseffi and M. Perlow, Vol. 27, No. 9, Insights (Sept. 2013).

[12] For guidance on drafting compliance policies and procedures related to static websites and social media, see the 2012 Risk Alert.

[13] *See* 2012 Risk Alert.